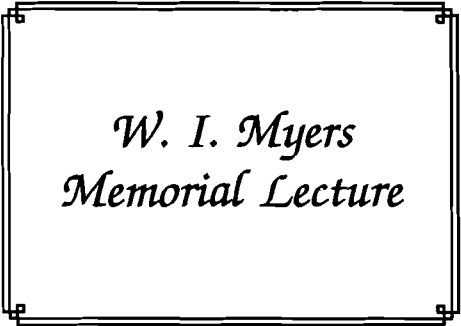


November 1992

A.E. Res. 92-11

INTERNATIONAL MONETARY ISSUES AND AGRICULTURAL DEVELOPMENT

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*W. I. Myers
Memorial Lecture*

October 22, 1992

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William I. Myers (1891-1976) was one of the early agricultural economists who worked on problems of agricultural finance. He was appointed a full professor of farm finance at Cornell University in 1920. In 1932, Professor Myers was asked to prepare recommendations for a legislative program to solve the agricultural finance problems of those times. His proposals found approval from President-elect Roosevelt, and his ideas formed the foundation for the creation of the Farm Credit Administration and the present Federal Cooperative Farm Credit System. Then, at the request of President Roosevelt, he was granted a leave of absence from Cornell in March 1933 to serve as assistant to Henry Morgenthau, then chairman of the Federal Farm Board. Morgenthau was appointed the first governor of FCA, and Myers became Deputy Governor. Then, when Morgenthau became Secretary of the Treasury in September 1933, Myers was appointed governor of the Farm Credit Administration. He served in that capacity until 1938 when he returned to Cornell University as head of the Department of Agricultural Economics. In 1943, he became Dean of the College of Agriculture serving until 1959.

The purpose of the W. I. Myers Memorial Lecture is to bring to this campus an outstanding agricultural finance economist to lecture on a timely topic. The lecture is sponsored by the Cornell University Department of Agricultural Economics as a part of its continuing emphasis in agricultural finance.

ABSTRACT

The value of a nation's currency is the most important price in its economy. Attempts to establish or maintain fixed exchange rates between countries are no longer possible due to the sheer size of international financial markets. The value of a nation's currency not only influences the relative prices between its tradeable and nontradeable sectors, it influences in very important ways a country relates to the rest of the international economy. The most significant effect of cyclical swings in exchange rates is the impact on trade where undervalued currencies amount to an export subsidy and an import tariff. U.S. foreign aid programs tend to strengthen the recipient country's foreign currency but hurt its development efforts. Needed stability in exchange rates can be achieved if countries pursue neutral monetary and fiscal policies.

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G. Edward Schuh**

It is a distinct honor to deliver the 1992 Myers Memorial Lecture. I did not know Professor Myers personally, but I almost feel as if I did through my many conversations with Lowell Hardin, an alumnus of the Cornell Department of Agricultural Economics. Professor Myers was truly a person who made a difference. It is appropriate that his memory be honored with both a Memorial Lecture and a Professorship in his name.

In choosing the subject for a Lecture such as this it always helps to be lucky. Not everybody could foresee back in June when John Brake and I first discussed the possibility of my giving this lecture that by the time we reached this date the world would have passed through a major monetary crisis to help sensitize potential participants to the importance of the topic.

I have kept the same theme John and I agreed to back in June. However, I plan to spend some time discussing the events of the past several months as part of my presentation.

* 1992 W.I. Myers Memorial Lecture, Cornell University, Ithaca, New York, October 22, 1992.

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My comments this evening are divided into four parts. The significance of monetary issues in the new configuration of the international economy is the first topic I take up. This is followed by a discussion of the global debt crisis of the 1980s and the drive to economic reform in the developing countries. Then we will consider the distortions created by foreign aid, and follow that with a discussion of the events in Europe in the past several months. At the end I will have some concluding comments.

The Significance of Monetary Issues

Anyone who went to Europe this past summer and paid three to four dollars for a common coke, or \$16 to \$18 for a modest breakfast, knows that monetary issues matter. Unfortunately, neither policy makers in this country nor those in Europe seem to appreciate that point. They try to obtain trade liberalization through the multilateral negotiations of the GATT without first obtaining more stable monetary conditions through reform of the international monetary system. They try to establish a new system of fixed exchange rates for Europe when the accumulation of 20 years of experience suggests it is not possible to do so. And the French continue to try to sustain a system of fixed exchange rates for their former colonies in Africa, despite the evidence that this system imposes severe hardship on particular countries in that system.

It seems that policy makers are like academics. They like to do things by habit. If they did it in the past, that seems to be perfect justification for continuing to do it in the present and future, never mind that economic conditions have changed and new perspectives are needed.

In the case of our international monetary system, there continues to be a tendency in some parts, and especially in Europe, to worship the Bretton Woods fixed exchange rate system that prevailed from the end of World War II up through the early months of 1973. There is a continued drive to return to the old system despite all the evidence that such a system is simply not feasible.

Why is a return to a fixed exchange rate system not feasible? The main reason is that international financial markets have become so large that it is no longer possible to fix exchange rates for the major currencies even if we want to. Total international financial flows dwarf international trade flows in today's world. International trade flows now run at about \$3 trillion per year. International financial flows now run about 15 times that amount. The pressures from flows in those markets become absolutely huge. The experience of recent months has shown that it is not possible to fix the rate of exchange for major currencies even when Germany, Japan, and the United States all cooperate in efforts to do so.

This is a serious case of institutional memory loss. The world had learned on an earlier occasion that fixing exchange rates was not feasible. The reason the United States forced the global monetary system to a system of bloc-flexible exchange rates back in 1973 was that despite best efforts to peg the value of the dollar after the devaluation of 1971, it was not possible to do so. It is sad that we have forgotten that important lesson in such a short period of time. There have been many wounded and injured from the recent monetary conflagration.

In addition to the above important point, three major issues need to be considered in taking our bearings on the consequences of monetary disturbances. The first is that distortions in the values of national currencies are the equivalent of distortions to trade. An overvalued currency, for example, is equivalent to a tax on exports and a subsidy on imports. Those interested in agricultural development, whether here or abroad, will appreciate the significance of such distortions to sound development policy. Similarly, an undervalued currency, such as the Japanese long pursued, is equivalent to an export subsidy and an import tariff. From the perspective of agricultural development, distortions which either overvalue or undervalue national currencies are of the highest importance.

The second issue is closely related. When some parts of the markets of a global system are fixed and not allowed to adjust, the result is an increase in instability in the remaining part of the system. D. Gale Johnson made that point in the case of

commodity markets some years ago. The same principle applies to foreign exchange markets. Thus, the fact that so many countries still try to fix the value of their national currencies contributes in very important ways to the observed instability in those parts of the foreign exchange system that are open and flexible.

The third issue has to do with the instability in foreign exchange markets. Many critics of flexible exchange rates point to the short term fluctuations in foreign exchange markets, and argue that that short term instability is damaging to trade because it increases risks and therefore transaction costs. However, the risk in transactions can be handled by hedging in the futures markets for foreign exchange. The real issue with the present system is not this short-term instability, but rather the fact that the values of national currencies experience long swings, on the order of six to eight years in length.

In the case of the U.S. dollar, for example, it experienced an almost continuous decline from 1973 to the end of 1979, a period of six years. Then it experienced an almost unprecedented rise from the end of 1979 to May 1985, another six year period. From that peak, the dollar has been in an almost continuous decline until the present time. The exception was a period towards the end of the 1980s, when the attempts by the Federal Reserve to dampen the economy caused the value of the dollar to rise for a number of years.

The problem with these long swings is that they mask underlying comparative advantage. For example, by 1979, after the export boom of the 1970s, U.S. farmers thought they could compete with anybody in the world. After six years of unprecedented rise in the value of the dollar, however, many of them became persuaded they couldn't compete with anybody. Both conclusions were wrong.

These large and extended swings in the value of national currencies also impose an almost continuous adjustment on the tradeable goods sectors, thus further sacrificing economic growth. In most countries, the agricultural sector produces a tradeable good. Most countries either export or import an agricultural commodity. Many do both.

To conclude, the emergence of huge, well-integrated international financial markets have contributed a great deal of monetary instability to foreign exchange markets. This instability creates distortions to international trade, and results in the sacrifice of a great deal of potential economic growth.

The Crises of the 1980s and the Drive to Economic Reform in the Developing Countries

Recall that the decade of the 1970s was a period of unprecedented economic growth in the global economy, especially among the developing countries. This economic expansion was fueled in large part by an explosion in the world's supply of money. Monetary authorities in many countries pursued easy money policies to

accommodate the shift in external terms of trade represented by the huge increase in petroleum prices. Moreover, there was a call by many observers of the international scene for the commercial banks to recycle the petrodollars that were accumulating in their accounts lest the international economy collapse.

The banks responded to this call for recycling with alacrity. Given the relatively high rate of inflation that ensued, interest rates in many cases were negative. Thus the developing countries were not being completely irrational when they absorbed these resources with enthusiasm. Moreover, they had other reasons for borrowing so extensively on the international capital market. The alternative was to undertake major devaluations of their currencies. Policy makers never like to devalue.

When OPEC engineered a second large increase in petroleum prices in 1979, the dollar went into a free-fall in foreign exchange markets. Paul Volcker, then chair of the Federal Reserve Board, hurried home from a conference in Europe to impose a draconian shift in U.S. monetary policy. In effect, the Federal Reserve Board decided that it would no longer print money to finance the already large deficit the U.S. government was running in its budget. Henceforth, the Treasury would have to borrow from the capital markets to finance the deficit.

We all know the results. Interest rates in the United States, and consequently in the rest of the world, increased dramatically. From negative real rates, they in a

relatively short period of time increased to 22 to 23 percent in real terms. With the United States being the source of this large monetary disturbance, this country began to attract a large flow of capital from around the world. The result of this capital inflow was an unprecedented rise in the value of the dollar, one that, as noted above, extended over a six-year period.

For U.S. agriculture the combination of these two events was a near disaster. The large rise in real interest rates caused a collapse in asset values not experienced since the decade of the 1930s. The rise in the value of the dollar, together with the increases in support levels for commodity prices in the aftermath of the Soviet invasion of Afghanistan, choked off U.S. agricultural exports, further complicating things for our producers.

The problem was even worse, however, for the developing countries that had been borrowing with such enthusiasm from international financial markets. Much of their debt, which was mainly held in dollars, was in the form of short-term loans. In a very short period of time they were forced to refinance this debt at much higher rates of interest. Moreover, with the large rise in the value of the dollar, they had to give up more and more in terms of domestic resources to acquire the dollars to service their debt. In effect, the developing countries were hit with a double shock. Thus was born the international debt crisis of the 1980s and a long period of economic stagnation in many of the developing countries.

As with many if not most painful events, there were some positive things that came from this period of crisis. For example, developing countries which had tended to tax their agriculture with highly overvalued currencies were forced to get their economic house in order by implementing more realistic exchange rate policies and generally undertaking economic reforms. This has been a painful process, and one that has stretched out for the greater part of a decade. Gradually, however, exchange rates have been realigned, national economies have been privatized, and economies in the developing world have been shifted to more market-oriented systems.

As we look to the international economy, the developing countries are now poised for a period of rapid economic growth. Countries such as Mexico and Argentina have undertaken major economic reforms and are already realizing the benefits. More generally, the share of export earnings from the developing countries that have to go to service international debt has declined to more realistic levels, and domestic economies are starting to recover.

This reform process has important implications for global agricultural markets. The major realignments of currency values in the developing countries have shifted the domestic terms of trade in those countries in favor of agriculture. In effect, policy makers are no longer imposing such large taxes on their agricultural sectors by means of overvalued currencies, nor are they subsidizing their imports of food and agricultural products by the same means. Agriculture is now positioned in these

countries to come closer to realizing its comparative advantage. Producers have stronger incentives to produce.

The trade implications of these painful economic adjustments go in two quite different directions. With the shift in the domestic terms of trade in favor of agriculture, that sector can be expected to perform better and come closer to satisfying domestic markets. With more realistic exchange rates, producers in those countries should also be better able to compete in international markets, and the elimination of implicit import subsidies should cause imports of food and agricultural products to decline.

On the other side of the coin, the reform of economic policy should promote a more rapid rate of economic growth in these developing countries. The favorable shift in the domestic terms of trade should assure that the benefits of that economic growth are more widely spread among the poor, most of whom are concentrated in rural areas. The increase in per capita incomes should increase the demand for food. The key issue for U.S. producers will be whether these increases in demand will outpace the ability of domestic agriculture to respond with increased output. Although a detailed analysis of that issue is beyond our interests here today, the presumption is that domestic agriculture in those countries will not be able to respond in an adequate way and thus we should expect import demand in those countries to rise.

Another factor at work to benefit the trade side of the picture is that the reform of domestic economic policies should attract an inflow of capital into those countries. This will help to make their currencies stronger in foreign exchange markets than they would otherwise be, and this in turn will provide incentives to import while at the same time taking some of the competitive edge off their exports.

To summarize, what we have seen is major economic reform efforts in the developing countries, driven largely by a large monetary disturbance. Most of these reform efforts are in the direction of making more efficient use of domestic resources, and in the direction of promoting domestic agricultural development. The limitations on agricultural development, on the other hand, will be imposed by the lack of capacity for agricultural research in those countries. Hence, as we look to the decade ahead, we should see growing markets for U.S. agricultural output, caveated only by our own ability to remain competitive in international markets.

It is worth noting in this context that our own monetary situation should work to the benefit of U.S. producers. We can expect to see the U.S. dollar remain weak in foreign exchange markets because of the huge international debt we have accumulated over the years. This should help U.S. agriculture remain competitive in international commodity markets.

The Distortions of Foreign Aid

In light of the rather general criticisms of foreign aid programs by U.S. producer groups, it is somewhat ironic that these groups tend to benefit in important ways from foreign aid programs. In particular, they tend to benefit from the monetary aspects of that foreign aid.

The problem in this case is that much of the global effort in foreign aid is still directed to providing balance of payments support. Providing foreign aid in this form is counterproductive in that it tends to make the value of currencies in countries receiving such aid stronger in foreign exchange markets than they would otherwise be. Uma Lele and her colleagues have shown how important this effect can be in the case of many of the African countries. The foreign aid actually gives these countries relatively strong currencies, which is just the opposite of what they need in light of the other goals of development policy.

The effect of these policies is again two-fold. First, it helps keep the domestic terms of trade in those countries shifted against agriculture. This makes it difficult to develop the agriculture in countries that receive aid in this form. It also provides implicit import subsidies, which causes these countries to depend more on foreign sources of supply than would otherwise be the case. As long as foreign aid continues to take this form, we can expect to see the agricultural development efforts in those countries proceed at a slow pace, especially in light of their limited capacity for agricultural research.

International foreign aid programs also impose another form of distortion in these countries. The international community, and especially the United States, continues to provide large amounts of food aid to the developing countries. This aid carries its own strong set of disincentives to the development of agriculture in those countries. Although the international community had at one time recognized these effects and was taking actions to minimize them, a new concept was coined and we are back at our old game. The new concept is the monetization of food aid, which means to sell it into the domestic market and recover the proceeds to use in support of government budgets and programs. As a little reflection will show, this sale into the domestic markets provides disincentives for domestic producers. Dumping by any other name is still dumping!

Let me conclude this section by noting that none of the above is to suggest that I am against foreign aid. To the contrary, if used in the right way, foreign aid can be in the best interests of U.S. producers since if the resources are used in the right way it can promote a more rapid rate of economic growth, generate increases in per capita incomes, and thus increase the demand for food and agricultural commodities. The foreign aid should be used to increase the productive capacity of the economy in these countries, however, and not for balance of payment support. Moreover, there are ways food aid can be used that will minimize the disincentive effects for domestic producers.

Recent Events in Europe

The recent events in Europe once again illustrate the potentially severe consequences of failing to manage international monetary issues in a proper manner. The problems have arisen because of the misguided attempt to have a fixed exchange rate system, and a failure to recognize the consequences of such a system.

Recall that the countries of Western Europe have for some years been operating with a foreign exchange rate system that is described as "the snake." It receives this label because the values of national currencies are for all practical purposes fixed, but still allowed to fluctuate within a narrow band. When observed over time, the time path tends to trace out what looks like the wiggles of a snake.

The goal of this system was two-fold. The first was to impose monetary discipline on those members of the Community who would not otherwise be willing to impose such discipline on themselves. The second was to provide some degree of flexibility that would allow time to adjust to changing economic realities.

Some years ago the Europeans reached agreement to do what they describe as "complete the market." This meant that they decided to eliminate all remaining barriers to trade within the Community, as well as all barriers to the mobility of resources. The goal was to have completed this exercise by the end of 1992, and thus the program was referred to as EC-92.

As this process proceeded, the issue of what kind of exchange rate system to have arose. Being by nature meddlers and interventionists, the Europeans decided to convert their national currencies to a common one. This in turn required that there be a central bank for Europe, and with a central bank goes the need for political unification. Political unification became attractive to some countries because it promised to give them some influence over the German Bundesbank, which under current circumstances has become central banker for the Community.

This drive for a central bank and political unification was a clear case of over-reach. The Community could have all the benefits of full economic integration without having a unified monetary system. And it could have those benefits with a flexible exchange rate system. One need look no further than the trade between Canada and the United States to see how such a system can work. Both countries have flexible exchange rate systems, and the volume of trade across the border is the largest between any two countries in the world. Moreover, there are large flows of capital between the two countries as well.

An important point on this issue is that stability in exchange rates can be obtained by means other than fixing the rates explicitly. The key is to pursue neutral monetary and fiscal policies. In other words, national governments should pursue monetary policies that consistently attempt to stabilize domestic price levels and fiscal policies that tend to balance the budget from year to year. A combination of these

policies will not fix the exchange rates at a given level, but it will keep them relatively stable over time. This is probably the best that can be done.

The unfortunate aspect to fixing exchange rates is that the system eventually breaks down, creating large monetary disturbances. It is out of such disturbances that protectionist pressures arise. In fact, the protectionist pressures begin to arise prior to the breakdown as one or more of the currencies becomes increasingly overvalued. The implicit import subsidy implied by such an overvaluation is what creates the pressures for protectionism.

To conclude this section, the attempt to establish a common exchange rate for the European Community will have significant effects on the domestic agriculture of the member countries. It will also have an important influence on trade flows and on pressures for protectionism. It would be better for all parties concerned if the Europeans were to change their current policy goals and go instead for a fully flexible exchange rate system.

Concluding Comments

The value of a nation's currency is the most important price in its economy. It not only influences the relative prices between its tradeable and nontradeable sectors, it influences in very important ways how the country relates to the rest of the international economy. This influence on how the economy relates to the global

economy is important on both the current accounts and on the capital accounts. Ironically, both policy makers and many academic economists tend to neglect this important set of issues. We should recognize that we do so at our own risk.

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